

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-4804-99
GAK:indel

date: SEP 13 1999

to: Examination Division, Southern California District
ATTN: Rick Woods, CE1108

from: Associate District Counsel, Southern California District, San Diego

subject: [REDACTED] - Sale of [REDACTED]

This memorandum responds to your request for advice regarding the sale of [REDACTED] ("Taxpayer"), a wholly owned subsidiary of [REDACTED] (the "Taxpayer") and certain transactions associated with this sale.

DISCLOSURE LIMITATIONS

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ISSUES

1. Whether [REDACTED]'s redemption of preferred stock held by [REDACTED] in or about [REDACTED] was "not essentially equivalent to a dividend" within the meaning of I.R.C. § 302(b)(1), where both [REDACTED] and [REDACTED] were wholly owned subsidiaries of the Taxpayer.
2. Whether the amount realized by the Taxpayer on the sale of [REDACTED] to [REDACTED] in or about [REDACTED] included the amount to be paid by [REDACTED] for the purchase of [REDACTED] preferred stock held by the Taxpayer, where:
 - a. as part of the transaction, the Taxpayer exchanged part of its common stock of [REDACTED] for preferred stock of [REDACTED]
 - b. [REDACTED] had an option to purchase the preferred stock from the Taxpayer for \$ [REDACTED] plus accrued but unpaid dividends; and
 - c. the Taxpayer had an option to require [REDACTED] to purchase the preferred stock for \$ [REDACTED] plus accrued but unpaid dividends.
3. Whether the Taxpayer properly computed the gain on the sale of [REDACTED] to [REDACTED].

CONCLUSIONS

1. No. Under the attribution rules of I.R.C. § 318, [REDACTED] is treated as owning all of the common stock of [REDACTED] before and after the redemption of preferred stock. Because [REDACTED]'s redemption of preferred stock held by [REDACTED] did not meaningfully reduce [REDACTED]'s ownership of [REDACTED], it is essentially equivalent to a dividend.
2. No. While the parties expected [REDACTED] ultimately to purchase the preferred stock from the Taxpayer, the options did not legally impose mutual obligations on the Taxpayer to sell and [REDACTED] to buy. Each party's obligation to act was contingent upon exercise of the option, an event that may not occur.
3. No. Under the regulations promulgated under I.R.C. § 1502, the Taxpayer may increase its basis in [REDACTED] common stock by the undistributed earnings and profits of [REDACTED]. According to the schedule provided by the Taxpayer, the Taxpayer increased its basis in [REDACTED] common stock by \$ [REDACTED] an amount reflecting the dividend received by [REDACTED] from [REDACTED].

[REDACTED]
[REDACTED]
3) [REDACTED]
[REDACTED]
[REDACTED] 's [REDACTED]
[REDACTED] ."

See [REDACTED] Letter. After this general proposal, the parties agreed on certain terms, including, the Taxpayer's right to take approximately \$[REDACTED] out of [REDACTED]. See letter dated [REDACTED], from [REDACTED] to the Taxpayer (the "[REDACTED] Letter").

The Taxpayer and [REDACTED] executed a letter of intent regarding the sale of [REDACTED] to [REDACTED] on [REDACTED]. Pursuant to the Letter of Intent, [REDACTED] would purchase [REDACTED] percent of the shares of [REDACTED] from the Taxpayer for \$[REDACTED]. The Letter of Intent then set forth the following conditions:

[REDACTED] Call by [REDACTED]

[REDACTED] [REDACTED]'s Put

[REDACTED] Formula Price

See Letter of Intent. The parties expected to enter into a formal purchase agreement within [REDACTED] months of the Letter of Intent.

B. REDEMPTION OF PREFERRED STOCK ISSUED BY [REDACTED]

On or after [REDACTED], [REDACTED] distributed \$ [REDACTED] and \$ [REDACTED] to [REDACTED] and [REDACTED],¹ respectively, in redemption of preferred stock of [REDACTED] held by [REDACTED] and [REDACTED]. Soon thereafter, [REDACTED] distributed \$ [REDACTED] to the Taxpayer.

It appears from the [REDACTED] U.S. Corporation Income Tax Return, Form 1120, filed by the Taxpayer and its subsidiaries, as well as other documents provided by the Taxpayer, that the Taxpayer treated (1) the redemption of preferred stock in [REDACTED] as a distribution essentially equivalent to a dividend and (2) the distribution of \$ [REDACTED] from [REDACTED] to the Taxpayer as a dividend to the extent of \$ [REDACTED] and a return of capital to the extent of \$ [REDACTED].

C. STOCK PURCHASE AGREEMENT DATED [REDACTED]

On [REDACTED], the Taxpayer and [REDACTED] executed a Stock Purchase Agreement in which the Taxpayer agreed to sell all of the issued and outstanding common stock of [REDACTED] to [REDACTED]. After the execution of the Stock Purchase Agreement but prior to the closing of the transaction, the Taxpayer exchanged [REDACTED] of its [REDACTED] shares of the common stock for Series A Preferred Stock of [REDACTED].

The agreement between the Taxpayer and [REDACTED] contains three basic elements: (1) the sale of common stock of [REDACTED] by the Taxpayer to [REDACTED] for \$ [REDACTED] plus a "Contingent Payment," (2) options held by both the Taxpayer and [REDACTED] to terminate the Contingent Payment, and (3) options held by both the Taxpayer and [REDACTED] regarding the purchase/sale of the Series A Preferred Stock held by the Taxpayer.

Sale of Common Stock

[REDACTED] agreed to pay the Taxpayer \$ [REDACTED] for the common stock of [REDACTED] on the date set for closing plus a "Contingent Payment" equal to the "Capitalized Earnings Factor" plus the "Interest Factor" on [REDACTED]. Both elements

¹ [REDACTED] is a wholly owned subsidiary of the Taxpayer.

constituted the purchase price of the [REDACTED] common stock. See Stock Purchase Agreement, §§ [REDACTED] and [REDACTED].

The term "Capitalized Earnings Factor" means "the average Income Before Taxes and before taking into account the Interest Factor of [REDACTED] . . . for three fiscal years, multiplied by a factor of [REDACTED], less [\$[REDACTED]]." See Stock Purchase Agreement, Article [REDACTED], Definitions. The term "Interest Factor" means "the excess (or deficit) calculated by deducting the total dividends paid on the Preferred Stock since issuance . . . from an amount equal to [REDACTED] % of the net earnings after taxes of [REDACTED] . . . for all fiscal years ended on or after [REDACTED] and the year in which Notice pursuant to section 1.3(e) is given". Id.

Options to Terminate the Contingent Payment

Pursuant to the Stock Purchase Agreement, either the Taxpayer or [REDACTED] can elect to terminate the Contingent Payment. The Stock Purchase Agreement sets forth the following conditions with respect to making the election:

[REDACTED] Contingent Payment.

. . .

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

See Stock Purchase Agreement, § [REDACTED].

It is unclear from the facts whether either the Taxpayer or [REDACTED] has exercised its option under Sections [REDACTED] or [REDACTED].

Options to Purchase/Sell Preferred Stock

Prior to the execution of the Stock Purchase Agreement, the Taxpayer was not authorized to issue any preferred stock. Prior to the closing of the transaction, however, the Taxpayer restated its articles of incorporation to authorize the issuance of [REDACTED] shares of preferred stock. Then, as noted above, the Taxpayer exchanged [REDACTED] shares of [REDACTED] common stock for [REDACTED] shares of Series A Preferred Stock.

The holders of the outstanding Series A Preferred Stock are entitled to receive in each fiscal year, when and as declared by

the Board of Directors, dividends in cash at the rate of \$[REDACTED] per share before any dividend is paid on the common stock. See Certification of Determination of Preferences of Preferred Stock of [REDACTED], \$[REDACTED]. The right to such dividend is cumulative and shall accrue at the rate of \$[REDACTED] per share whether or not dividends are declared or earned. Id. In the event a liquidation, the holders of the outstanding Series A Preferred Stock are entitled to receive an amount equal to \$[REDACTED] per share and a further amount equal to any dividends declared and unpaid on the date of the liquidation. Id. at \$[REDACTED].

The Series A Preferred Stock is subject to redemption in whole or in part at any time at the option of the Board of Directors or at the option of the holder. Id. at \$[REDACTED]. The Series A Preferred Stock has no voting rights. Id. at \$[REDACTED].

Pursuant to the Stock Purchase Agreement, the Taxpayer had the option at any time to require [REDACTED] to purchase all of the Series A Preferred Stock for \$[REDACTED] plus accrued but unpaid dividends. [REDACTED] had the option, at the time it elected to pay the Contingent Payment, to purchase all of the Series A Preferred Stock from the Taxpayer for \$[REDACTED] plus accrued but unpaid dividends. The Stock Purchase Agreement contains the following provisions:

[REDACTED] Options on Preferred Stock.

[REDACTED]

[REDACTED]

[REDACTED]

See Stock Purchase Agreement, § [REDACTED]

The Taxpayer received dividends in the amount of \$[REDACTED] in fiscal years ending [REDACTED], [REDACTED], and [REDACTED]. The Taxpayer sold its Series A Preferred Stock to [REDACTED] in [REDACTED] for \$[REDACTED].

D. REPORTING OF SALE OF [REDACTED]

The Taxpayer reported a loss in the amount of \$ [REDACTED] on the sale of [REDACTED] to [REDACTED] on its [REDACTED] U.S. Corporation Income Tax Return, Form 1120. The loss is disallowed pursuant to Treasury Regulation § 1.1502-20.

The Taxpayer reported the amount realized on the sale of [REDACTED] common stock as \$ [REDACTED]². The Taxpayer calculated its basis in [REDACTED] common stock as follows:

Investment in [REDACTED] as of [REDACTED]	\$ [REDACTED]
Book Income [REDACTED] to [REDACTED]	[REDACTED]
Redemption of [REDACTED] Preferred Stock Treated as Dividend	[REDACTED]
Nondeductible Reserves	[REDACTED]
Tax Return Adjustments Lookback Interest	[REDACTED]
Tax Effect of Adjustments Federal	[REDACTED]
State	[REDACTED]
[REDACTED]	[REDACTED]
Less Retained Earnings at [REDACTED]	[REDACTED]
Tax Basis before Preferred Stock	\$ [REDACTED]
Basis Allocable to Preferred Stock	[REDACTED]
Basis of Common Stock	\$ [REDACTED]

As noted above, the Taxpayer reported a loss of \$ [REDACTED] on the sale. The Taxpayer also showed a book gain of \$ [REDACTED] on the sale.

² It is our understanding that the Taxpayer initially reported the amount realized as \$ [REDACTED] but amended its [REDACTED] Form 1120 to reflect the amount realized as \$ [REDACTED].

DISCUSSION

I. REDEMPTION OF PREFERRED STOCK ISSUED BY [REDACTED]

A redemption of stock³ by a corporation is treated as a distribution in part or full payment in exchange for the stock, if the redemption satisfies one of the following four tests:

1. the redemption is not essentially equivalent to a dividend;
2. the redemption is substantially disproportionate within the meaning of I.R.C. § 302(b)(2);
3. the redemption results in the complete termination of the shareholder's interest in the corporation; or
4. the redemption is made with respect to a non-corporate shareholder and is made in partial liquidation of the redeeming corporation within the meaning of I.R.C. § 302(b)(4).

I.R.C. §§ 302(a) and (b). If a redemption of stock does not meet any of the tests described above, it is treated as a distribution to which I.R.C. § 301 applies. I.R.C. § 302(d).

Attribution Rules

Before the tests of I.R.C. § 302(b) can be applied, the ownership of the stock must be determined using the attribution rules of I.R.C. § 318(a). I.R.C. § 302(c). Pursuant to I.R.C. § 318(a)(3)(C), a corporation is considered as owning the stock owned, directly or indirectly, by a shareholder, if that shareholder owns, directly or indirectly, 50 percent or more in value of the stock of the corporation.

Prior to [REDACTED]'s redemption of preferred stock held by [REDACTED] the Taxpayer owned [REDACTED] percent in value of the common stock of [REDACTED] and [REDACTED], and [REDACTED] owned preferred stock of [REDACTED]. Pursuant to the attribution rules of I.R.C. § 318(a)(3)(C), [REDACTED] is considered as owning [REDACTED] percent of the common stock of [REDACTED] in addition to the preferred stock it actually owned. After [REDACTED]'s

³ Stock is treated as redeemed by a corporation, if the corporation acquires its stock from a shareholder in exchange for property, including money, whether or not the stock is canceled, retired, or held as treasury stock. I.R.C. § 317(b).

redemption of preferred stock, the Taxpayer still owned [REDACTED] percent in value of the common stock of [REDACTED] and [REDACTED] did not own any common stock or preferred stock of [REDACTED]. Pursuant to I.R.C. § 318(a)(3)(C), however, [REDACTED] still is considered as owning [REDACTED] percent of the common stock of [REDACTED].

Because [REDACTED] is considered as owning [REDACTED] percent of the common stock of [REDACTED] both before and after [REDACTED]'s redemption of preferred stock held by [REDACTED], [REDACTED]'s redemption of preferred stock cannot satisfy any of the tests described in I.R.C. § 302(b).

Redemption in Partial Liquidation

The test under I.R.C. § 302(b)(4) requires a distribution made in redemption of stock held by a shareholder who is not a corporation and made in partial liquidation of the distributing corporation. Clearly, this test is not applicable to this case, because [REDACTED] the shareholder receiving the distribution, is a corporation.

Redemption in Complete Termination of Interest

The test under I.R.C. § 302(b)(3) requires a distribution in complete termination of all of the stock of the corporation owned by the shareholder. In this case, [REDACTED] distributed cash to [REDACTED] in exchange for all of the stock directly owned by [REDACTED]. But [REDACTED] is considered as owning [REDACTED] percent of the common stock of [REDACTED] under I.R.C. § 318(a)(3)(C). As a consequence, the distribution did not result in a complete termination of [REDACTED]'s interest in [REDACTED] and the distribution does not meet the test under I.R.C. § 302(b)(3).

Substantially Disproportionate Redemption

A distribution is substantially disproportionate if the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at that time is less than 80 percent of the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at that time. I.R.C. § 302(b)(2).

It is our understanding that the only stock with voting rights was the common stock directly owned by the Taxpayer. Because, as noted above, [REDACTED] constructively owned [REDACTED] percent of the voting stock of [REDACTED] immediately before and after [REDACTED]'s redemption of preferred stock, the distribution is not a

substantially disproportionate redemption within the meaning of I.R.C. § 302(b)(2).

Redemption Not Essentially Equivalent to Dividend

For a redemption to be "not essentially equivalent to a dividend," the redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. United States v. Davis, 397 U.S. 301, 313 (1970). In a case where a corporation redeems part of the shares held by its sole shareholder, the redemption is always "essentially equivalent to a dividend" within the meaning of I.R.C. § 302(b)(1). Id. at 307.

Because of the attribution rules of I.R.C. § 318(a)(3)(C), [REDACTED] is considered to be the sole shareholder of [REDACTED]. Therefore, [REDACTED]'s redemption of preferred stock held by [REDACTED] is essentially equivalent to a dividend. See id. at 307, 313; see also Rev. Rul. 85-106, 1985-2 C.B. 116.

The Service argues, however, that the redemption is "not essentially equivalent to a dividend," because the amount received in exchange for the preferred stock represents [REDACTED]'s investment in [REDACTED] and [REDACTED]'s redemption of the preferred stock is a meaningful reduction of [REDACTED]'s investment. In support of its position, the Service cites to Revenue Ruling 77-426, 1977-2 C.B. 87.

The Service's reliance on Revenue Ruling 77-426 is misplaced. In this ruling, the corporation had voting common stock and nonvoting preferred stock outstanding. The corporation redeemed a portion of the preferred stock, all of which was owned by one shareholder who did not own any "common stock of the corporation either directly or by application of the constructive ownership of stock rules of section 318 of the Code." Rev. Rul. 77-426. The Service held that "the redemption of any amount of stock that is nonvoting, nonconvertible, and limited and preferred as to dividends and in liquidation represents a meaningful reduction of the shareholder's proportionate interest in the corporation if the shareholder does not own stock of any other class, either directly or indirectly. Id. (emphasis added).

In this case, [REDACTED] constructively owned [REDACTED] percent of the common stock of [REDACTED] both before and after [REDACTED]'s redemption of preferred stock. As a consequence, the holding of Revenue Ruling 77-426 is not applicable.

Conclusion

Because none of the provisions of I.R.C. § 302(b) apply to the distribution, I.R.C. § 302(a) does not apply. I.R.C. § 302(a). I.R.C. § 301, however, does apply to the distribution. I.R.C. § 302(d).

Application of I.R.C. § 301

A distribution of property made by a corporation with respect to its stock is treated

1. first, as a "dividend" to the extent that the distribution is made out of earnings and profits,
2. second, as a return of capital to the extent of the shareholder's basis in such stock, and
3. third, as gain from the sale of property to the extent that the distribution exceeds the shareholder's basis in such stock.

I.R.C. §§ 301(a) and (c) and 316(a).

At this point, we do not have sufficient information to determine to what extent the distribution constitutes a dividend, return of capital, or gain. We recommend that the Service

(b)(5)(AC), (b)(7)a

Alternative Position

We recommend that the Service consider whether it should

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

A. EXCHANGE OF COMMON STOCK FOR PREFERRED STOCK

No gain or loss is recognized upon an exchange of stock or securities in a corporation a party to a reorganization which is made pursuant to a plan of reorganization and which is made solely for stock or securities in such corporation or in another corporation a party to the reorganization. I.R.C. § 354(a).

The term "reorganization" includes, among others, a recapitalization. I.R.C. § 368(a)(1)(E). A "recapitalization" takes place if, for example, a corporation issues preferred stock in exchange for common stock. See Treas. Reg. § 1.368-2(e)(3); see also Rev. Rul. 83-119, 1983-2 C.B. 57. The term "plan of reorganization" refers to a consummated transaction specifically defined as a reorganization under I.R.C. § 368(a). Treas. Reg. § 1.368-2(g).

As contemplated by the Stock Purchase Agreement, the Taxpayer exchanged [REDACTED] of its [REDACTED] shares of [REDACTED] common stock for [REDACTED] shares of [REDACTED] preferred stock. This exchange qualifies as a recapitalization under I.R.C. § 368(a)(1)(E) and results in no gain or loss being recognized by the Taxpayer at the time of the exchange.

Immediately after the exchange, the Taxpayer had a basis in its shares of preferred stock equal to its basis in the shares of common stock relinquished in the exchange. I.R.C. § 358.

B. TREATMENT OF CONTINGENT PAYMENT

(b)(5)(AC), (b)(7)a

[REDACTED]. If the Service needs any assistance in this regard, we will gladly provide it.

C. TREATMENT OF PREFERRED STOCK

The Service argues that the amount realized on the sale of [REDACTED] common stock by the Taxpayer to [REDACTED] should include the amount to be paid by [REDACTED] to the Taxpayer pursuant to the options to put or call the [REDACTED] preferred stock. The Service argues that the sale of the [REDACTED] preferred stock was consummated in [REDACTED] because (1) the Taxpayer would have opted to sell [REDACTED] outright to [REDACTED] if [REDACTED] had agreed to the proposed purchase price, and (2) the parties always expected [REDACTED] to purchase the [REDACTED] preferred stock from the Taxpayer.

(i.e., the possibility that the put or call would not be exercised was so remote that it should be ignored).

The date on which a sale is consummated for tax purposes depends all of the facts and circumstances surrounding the transaction. Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978); Bradford v. United States, 444 F.2d 1133 (Ct. Cl. 1971). The "transaction must be viewed as a whole and in light of realism and practicality." Bradford, 444 F.2d at 1143 (quoting Commissioner v. Segall, 114 F.2d 706, 709 (9th Cir. 1940)).

In this case, it seems fairly clear that the benefits and burdens of ownership of the [REDACTED] preferred stock did not pass to [REDACTED] during [REDACTED]. First, the Taxpayer, by virtue of its ownership of the [REDACTED] preferred stock, continued to participate in the profits of [REDACTED]. Specifically, the Taxpayer was entitled to receive, and did in fact receive, dividends with respect to the [REDACTED] preferred stock. Second, the Taxpayer continued to participate in the management of [REDACTED]. According to the Letter of Intent, the board of directors of [REDACTED] consisted of [REDACTED] people, [REDACTED] of whom were nominees of the Taxpayer and [REDACTED] of whom were nominees of [REDACTED]. See Letter of Intent, p. [REDACTED]. Third, the put and call arrangement between the Taxpayer and [REDACTED] did not legally impose mutual obligations on the Taxpayer to sell and [REDACTED] to buy; each party's obligation to act was contingent upon exercise of the put or call, an event that may not occur. See Penn-Dixie, 69 T.C. at 843-45.⁴

Admittedly, at the time of the Stock Purchase Agreement, both parties expected [REDACTED] ultimately to purchase the [REDACTED] preferred stock from the Taxpayer. But it is possible that the parties could reevaluate their goals and expectations in light of any changing circumstances. See id. at [REDACTED]. In addition, an intent to sell is not synonymous with a sale. Id. at [REDACTED].

Thus, the Stock Purchase Agreement did not sufficiently commit the Taxpayer and [REDACTED] to a sale of the [REDACTED] preferred stock as of [REDACTED].

III. COMPUTATION OF GAIN ON SALE OF [REDACTED]

The regulations promulgated under I.R.C. § 1502 provide special rules for calculating the gain or loss on the disposition

⁴ See also Priv. Ltr. Rul. 8735009 and Priv. Ltr. Rul. 8609010. While private letter rulings do not provide any precedential authority, they do provide a glimpse at the Service's analysis in similar situations.

of stock of a subsidiary which is a member of a consolidated group. Specifically, the regulations provide special rules on calculating the basis that a corporation has in stock of its subsidiary. Treas. Reg. § 1.1502-11(b). For purposes of determining gain or loss on the disposition of such stock,

(i) Consolidated taxable income or consolidated net operating loss (and earnings and profits or deficit in earnings and profits) for the taxable year shall be determined tentatively without regard to gain or loss on disposition,

(ii) The adjustments under § 1.1502-32(b) with respect to the stock disposed of shall be based upon the amounts determined under subdivision (i) of this subparagraph, and

(iii) Gain (including any amount included in income under § 1.1502-19(a)) or loss on disposition shall be determined in accordance with such adjustments to basis.

Treas. Reg. § 1.1502-11(b)(2).

Generally, at the end of each consolidated return year, each member owning stock in a subsidiary will adjust the basis of such stock in the manner prescribed in Treasury Regulation § 1.1502-32. Treas. Reg. § 1.1502-32(a). If a member disposes of stock of a subsidiary before the end of the taxable year, the member will adjust the basis of such stock on the date of disposition. Id. The amount of the adjustment is the difference between the positive adjustment and the negative adjustment. Id.

The "positive adjustment" with respect to share of stock is the sum of:

(i) An allocable part of the undistributed earnings and profits of the subsidiary for the taxable year;

(ii) An allocable part of the portion of any consolidated net operating loss or consolidated net capital loss for the taxable year which is attributable to such subsidiary under § 1.1502-79(a)(3) or (b)(2), and which is not carried back and absorbed in a prior taxable year; and

(iii) If such subsidiary owns stock in another subsidiary and § 1.1502-33(c)(4)(i) applies to the

taxable year, an allocable part of the net positive adjustment made by the higher tier subsidiary for the taxable year with respect to its stock in such other subsidiary.

Treas. Reg. § 1.1502-32(b)(1). The term "undistributed earnings and profits" means earnings and profits for the taxable year after diminution by reason of distribution of dividends (as defined in Treasury Regulation § 1.1502-14(a)(1)). Treas. Reg. § 1.1502-32(d)(8).

The "negative adjustment" with respect to a share of stock is the sum of

(i) An allocable part of the deficit in earnings and profits of the subsidiary for the taxable year (determined under § 1.1502-33);

(ii) An allocable part of any net operating loss or net capital loss incurred by the subsidiary in a prior separate return year, and of any portion of a consolidated net capital loss incurred by the group in a prior consolidated return year which is attributable to such subsidiary under § 1.1502-79(a)(3) or (b)(2), and which is carried over and absorbed in the taxable year;

(iii) Distributions made by the subsidiary during the taxable year with respect to such share out of earnings and profits of the subsidiary --

(a) Accumulated in prior consolidated return years beginning after December 31, 1965;

. . .

(c) Accumulated in separate return limitation years of the subsidiary, if the distribution occurs after August 9, 1979; and

(iv) If such subsidiary owns stock in another subsidiary and § 1.1502-33(c)(4)(i) applies to the taxable year, an allocable part of the net negative adjustment made by the higher tier subsidiary for the taxable year with respect to its stock in such other subsidiary.

Treas. Reg. § 1.1502-32(b)(2).

For purposes of calculating the positive and negative adjustments described above, the "earnings and profits" of a member is determined under Treas. Reg. § 1.1502-33. Treas. Reg. 1.1502-32(d). Generally, dividend distributions from one member to another member are reflected in the earnings and profits of such members. Treas. Reg. § 1.1502-33(c)(1). If the member must make an adjustment under Treasury Regulation § 1.1502-32 prior to the end of the taxable year of the subsidiary, the member will prorate the earnings and profits for the taxable year on a daily basis.

In this case, it does not appear that the Taxpayer has calculated its basis in [REDACTED] stock properly. Specifically, the Taxpayer has increased its basis in [REDACTED] common stock by more than the "undistributed earnings and profits" of [REDACTED] for the taxable year. See Treas. Reg. §§ 1502-32(b)(1) and 1.1502-32(d)(8). [REDACTED] received a distribution of \$ [REDACTED] from [REDACTED] during the fiscal year ending [REDACTED]. After receiving this distribution, [REDACTED] immediately distributed \$ [REDACTED] to the Taxpayer. Therefore, the Taxpayer may increase its basis in [REDACTED] common stock by \$ [REDACTED], the amount of "undistributed earnings and profits" for the taxable year associated with the distribution from [REDACTED].

Stated differently, the Taxpayer did not reduce its basis in [REDACTED] common stock by the distribution of \$ [REDACTED] that was made by [REDACTED] to the Taxpayer during the fiscal year ending [REDACTED]. The distribution of \$ [REDACTED] to the extent it is made out of earnings and profits, results in a negative adjustment to the Taxpayer's basis in [REDACTED] common stock. Treas. Reg. § 1.1502-32(b)(2)(iii). Because [REDACTED]'s redemption of preferred stock held by [REDACTED] resulted in a dividend to [REDACTED], [REDACTED] increased its earnings and profits by that amount. Treas. Reg. § 1.1502-33(c). This increase in earnings and profits exceeds the amount of the distribution made by [REDACTED] to the Taxpayer. As a consequence, [REDACTED] had sufficient earnings and profits to cover the distribution, and the Taxpayer must make the appropriate reduction in its basis in [REDACTED] common stock.

We recommend that the Service take the following steps in order to resolve this issue:

1. [REDACTED] (b)(5)(AC), (b)(7)a
2. [REDACTED] (b)(5)(AC), (b)(7)a
3. [REDACTED]


4. (b)(5)(AC), (b)(7)a
5. (b)(5)(AC), (b)(7)a
- 6.

If the Service would like assistance in resolving this issue, we will gladly provide it.

If you have any questions, please call the undersigned at (619) 557-6014.

GORDON L. GIDLUND
Assistant District Counsel

By:



GRETCHEN A. KINDEL
Attorney